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No. 86-1825

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LEONARD BRAWER,

Petitioner,

vs.

THE OPTIONS CLEARING CORPORATION and AMERICAN STOCK EXCHANGE, INC.,

Respondents.

JOINT BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. Should this Court issue a writ of *certiorari* to consider the viability of a 40 year old decision of the Court of Appeals, notwithstanding the facts that (1) the Court of Appeals, in this case, has itself expressly declined to consider that decision, (2) the basis for such decision has been undercut by the 1975 Amendments to the Securities Exchange Act of 1934 (the "Act") and recent Supreme Court standards for implying a private right of action and (3) there is no live conflict between such decision and the decisions of other Courts of Appeals?

2. Can an implied right of action against either a national securities exchange or a registered clearing agency for the alleged failure to comply with its own rules be maintained in the absence of an allegation of fraud or bad faith?

3. Was the Court of Appeals' dismissal of this case proper in light of Petitioner's failure to plead facts from which fraud or bad faith could be inferred or to make any showing that such facts could be pleaded?

RULE 28.1 LIST

Respondent The Options Clearing Corporation ("OCC") has no parent companies, subsidiaries (except wholly-owned subsidiaries) or affiliates, except that each of the American Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Stock Exchange, Inc., the Philadelphia Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. owns 1/6 of the outstanding capital stock of OCC and each is entitled to elect one director to OCC's 16-member board of directors.

Respondent American Stock Exchange, Inc. furnishes the following list of parent companies, subsidiaries (except wholly-owned subsidiaries) and affiliates:

Depository Trust Company
National Securities Clearing Corporation
Securities Industry Automation Corporation
The Options Clearing Corporation

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JOINT BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

STATEMENT OF THE CASE

The Regulatory Context

Respondent American Stock Exchange, Inc. ("AMEX") maintains an exchange market for the trading of standardized options—including put and call options on the common stock of Phillips Petroleum Company ("Phillips"). The operation of options markets by AMEX and other securities exchanges is subject to the plenary rulemaking and supervisory authority of the Securities and Exchange Commission (the "SEC" or "Commission"). To maintain its options trading program, AMEX had to obtain

Commission approval of its pertinent rules pursuant to Section 19(b) of the Act.[1] In order for the Commission to grant such approval, it was required to find that AMEX and its rules met the requirements of Section 6(b) and the other provisions of the Act.[2]

Respondent The Options Clearing Corporation ("OCC") maintains a system for the issuance, settlement, and exercise of options traded on AMEX and other securities exchanges. OCC's clearing system is established under OCC's By-Laws and rules, which were approved by the Commission in 1983 when OCC's registration as a clearing agency under Section 17A(b)(3) of the Act became effective.

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[1] Section 19(b) requires each self-regulatory organization ("SRO") to file with the Commission copies of any proposed rule or rules change accompanied by a concise general statement of its basis and purpose. The Commission is then required to publish notice of the filing, together with the terms or substance of the proposed rule, giving interested persons an opportunity to submit written data, arguments and views. Within certain time constraints, the Commission must either approve the proposed rule or institute proceedings to determine whether it should be disapproved. 15 U.S.C. §§ 78s(b)(1) and (b)(2).

[2] The Commission was required to find, among other things, that AMEX had the capacity to comply, and to enforce compliance, with the provisions of the Act, the rules thereunder, and AMEX's own rules and that its rules met the purposes specified in Section 6(b), including the removal of impediments to, and the perfection of, a free and open marketplace, and, in general, the protection of investors and the public interest. 15 U.S.C. § 78f(b).

The Adjustment Rule

The applicable rules of the Respondents are Article VI, Section 11 of OCC's By-Laws (the "Adjustment Rule") and AMEX Rules 902 and 903(c) and (d). (A. 48-50).[3] However, the AMEX rules do not require specific adjustments of options; they provide only that options traded on AMEX are "subject to" adjustment in accordance with OCC's rules. (A. 49).

Contrary to Petitioner's claim that adjustments are "required" by OCC's By-laws (Petition 5), OCC's Adjustment Rule gives OCC's Securities Committee the "sole discretion" to make adjustments in the case of a "reorganization, recapitalization, reclassification or similar event" in respect of any underlying security. Petitioner's insistence on mischaracterizing this By-law was dealt with succinctly by the Court of Appeals:

> Brawer's argument that OCC's adjustment rule is not discretionary need not detain us long. Although the rule employs the imperative "shall", it also vests the decision as to what adjustments should be made "in the sole discretion" of the Securities Committee. OCC and AMEX read the rule as allowing the Securities Committee discretion whether to make any adjustments at all. We agree. (citations omitted).

(A. 12-13).

Petitioner's stubborn refusal to acknowledge the "sole discretion" language of the Adjustment Rule is matched by his intransigence in claiming, as a matter of undisputed fact, that the Phillips transaction that allegedly damaged Peti-

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[3] Citations in the form of "(A.)" are to the Appendix to the Petition for Writ of *Certiorari*. Citations to the Petition are in the form of "(Petition)".

tioner was a "recapitalization." (Petition 26). Petitioner compounds this error by claiming, in a bold misstatement of the record, that "[n]o one has taken issue with the proposition that the . . . decision not to adjust was clear error" and that "[n]o one has taken issue with the proposition that the failure to adjust resulted in the misallocation of approximately $15 million." (Petition 26).

The Court of Appeals recognized that "[t]he parties disagree as to whether the [transaction] should be designated a 'recapitalization' or an 'exchange offer.'" (A. 8, n.5). The Phillips' prospectus relating to the transaction refers to it throughout as an "Offer" or "Exchange Offer." Similarly, the investment bankers who advised Phillips' Board of Directors referred to the transaction as an "exchange offer." According to the prospectus, Phillips commenced the "Offer" after an earlier proposed transaction, which Phillips referred to as a "recapitalization," had failed to win Phillips' shareholders' approval. As the Court of Appeals recognized, the Securities Committee's decision not to adjust was "in accordance with longstanding policy." (A. 8-9).[4]

Petitioner suggests that the Adjustment Rule may be analogized to anti-dilution provisions contained in certain financial instruments. (Petition 5-7). However, unlike the Adjustment Rule—pursuant to which OCC acts as an

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[4] The market was apparently aware of the Respondents' practice of not adjusting for exchange and tender offers. As Petitioner acknowledged below, the price of Phillips put options rose immediately at the opening of the market on the first business day after Phillips' announcement of the "Offer," prior to any action by the Respondents, and continued to climb throughout the week. (A. 8).

"umpire" of the rights of others—anti-dilution provisions contained in the type of financial instruments described by Petitioner are negotiated between parties acting in their respective self-interests. Moreover, there are vast differences among anti-dilution provisions and no general agreement as to what events should be covered in each case. Indeed, many of the events listed in the American Bar Foundation, Commentaries on Indentures, cited by Petitioner (Petition 5-6), such as "distribution of assets, issuance or sale of other convertible securities, issuance of options [or] issuance or sale of common stock at prices below the current conversion or market price" are often not covered by anti-dilution provisions. The debate over which events should be included in particular provisions is one of the very reasons why the Securities Committee of OCC was granted the latitude of "sole discretion" in determining whether and how adjustments should be made. The OCC By-law on which Petitioner bases his claim does not contain the listing of operative events contained in the Commentaries.

REASONS FOR DENYING THE WRIT

Petitioner's opening hyperbole—apparently designed to exploit current insider-trading headlines—mischaracterizes the very people he has sued. These "powerful and sophisticated professionals" and "lords of the market" who decided that Petitioner should not reap the windfall he sought were, in fact, salaried officers/employees of two SROs who had no affiliation whatever with any member firm of those organizations nor any other investment house. In suggesting that only he stands between the integrity of SROs and chaotic self-interest, he denies the existence and impact of the 1975 Amendments to the Act (the "1975 Amendments") which

were designed to strengthen the Commission's oversight and enforcement powers with respect to SROs and to "insure that [SROs] exercise their delegated governmental power effectively to meet regulatory needs in the public interest and that they do not exercise that delegated power in a manner inimical to the public interest or unfair to private interests." S. Rep. No. 75, 94th Cong., 1st Sess. 34 (1975) (the "Senate Report"), *reprinted in* 1975 U.S. Code Cong. & Admin. News 212. As the Senate Report made clear, the 1975 Amendments "would significantly increase the regulatory options available to [the Commission] to deal with perceived self-regulatory shortcomings." *Id.*

For all intents and purposes, Petitioner refuses to recognize even the existence of the Commission and its oversight role. Petitioner would deny any latitude to the SROs in their function as market "umpires" and, indeed, asserts the right to sue the "umpires" under an ordinary negligence standard, requiring SROs to act at their peril in making the prompt day-to-day decisions in the interest of maintaining fair and orderly markets. Further, Petitioner misapprehends the role which Congress envisioned for SROs, under Commission oversight, in the 1975 Amendments.

The interaction of the 1975 Amendments and this Court's decisions relating to implied rights of action is a matter of some complexity. In the decade since the passage of the 1975 Amendments, no Court of Appeals has addressed the matter as it applies to the actions against SROs for non-enforcement of their own rules. It is telling that the Court of Appeals chose not to do so in this very case. This Court should not offer what would amount to an advisory opinion since, as discussed below, there are good reasons why Courts of Appeals have not addressed the question.

I. NO WRIT SHOULD ISSUE TO REVIEW THE APPLICATION OF *BAIRD* V. *FRANKLIN* TO THIS CASE BECAUSE:

A. There Is No Conflict Among The Circuits.

Petitioner appears to assert that the writ should issue because there is a "live conflict" as to whether *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944), "remains good law after the 1975 Amendments to the Act and recent Supreme Court decisions." (A. 5; Petition 12,14). The only "live conflict," however, is between two district courts within the Second Circuit (namely, the district court in this case (*see* 633 F. Supp. 1254 (S.D.N.Y. 1986)) and the district court in *Rich* v. *New York Stock Exchange* (*see* 509 F. Supp. 87 (E.D.N.Y. 1981))). (A. 5).

Rule 17.1(a) of this Court lists, as the first "special and important" reason for granting a writ, the rendering of ". . . a decision in conflict with the decision of another federal court of appeals on the same matter . . . " Although Petitioner clearly relies on this rule in asking this Court to "resolve conflicts concerning whether an investor has an implied claim against an SRO . . . " (Petition 13), he fails to explain that this conflict is among two district courts within the same circuit.

Petitioner also cites *Walck* v. *American Stock Exchange*, 687 F.2d 778 (3rd Cir. 1982), *cert. denied*, 461 U.S. 942 (1983), as a case which has disagreed with *Baird* v. *Franklin*. *Walck*, however, like *Baird*, was decided under the Act as it existed prior to the 1975 Amendments. Thus the "conflict" is a straw man and, at most, an historic curiosity. Whether the decisions of two circuits differed on a proposition which is now moot would seem to be an exercise on which this Court ought not to spend its time.

B. It Would Be Inappropriate For The Court To Review This Case On An Issue Which The Court Below Explicitly Refused To Consider.

This Court has long restrained itself from deciding issues not addressed in the Court of Appeals. *Montana Ry. Co.* v. *Warren*, 137 U.S. 348, 351 (1890); *Old Jordan Mining & Milling Co.* v. *Societe Anonyme Des Mines De Lexington*, 164 U.S. 261, 265 (1896).

> This Court sits as a court of review. It is only in exceptional cases coming here from the federal courts that questions not pressed or passed upon below are reviewed.

Duignan v. *United States*, 274 U.S. 195, 200 (1927). *See also J. Truett Payne Company, Inc.* v. *Chrysler Motors Corporation*, 451 U.S. 557, 568 (1981).

This case is the antithesis of the "exceptional case." The Court of Appeals not only failed to decide the issue which Petitioner raises, but it did so deliberately and explicitly. More importantly, the Court of Appeals' avoidance of the issue was entirely fathomable. First, neither *Baird* nor any other case cited below by Petitioner held that a private right of action could be implied against an exchange or clearing agency based on the SRO's alleged failure to comply with its own rules (as opposed to failure to enforce compliance by members with the SRO's rules). Thus, the Court of Appeals implicitly recognized that, for a private right of action to exist in this case, *Baird* would have to be "*extended* after the 1975 Amendments to support a private cause of action for an SRO's failure to comply with its own rules. . . ." (emphasis added) (A. 5, n.2).

Second, even if the implied private right of action issue had been resolved in favor of Petitioner below, it would not have changed the result below. The Court of Appeals chose,

as this Court should choose, to optimize judicial economy. When it became clear that Petitioner had not adequately alleged bad faith or fraud, it was also clear that an extensive and complex analysis of the recent cases of this Court involving implied private rights of action and the 1975 Amendments themselves would be gratuitous and unnecessary. In this Court, too, Petitioner would fail even if he were to succeed in convincing this Court to revive and extend the application of *Baird* v. *Franklin* to support a private cause of action for an SRO's failure to comply with its own rules, since he has failed adequately to allege fraud or bad faith.[5]

Third, as noted above, this Court has usually found it unwise to venture into issues—particularly complex, highly specialized statutory, and related policy, questions—when the Court of Appeals has not addressed them below.

C. *Baird* v. *Franklin* Has No Vitality Since The 1975 Amendments.

That *Baird* v. *Franklin* is an anachronism not worthy of consideration by this Court becomes apparent upon analysis of the private right of action issue. First, it is undisputed that none of the sections of the Act upon which Petitioner relies provides for a private right of action. Indeed, two of those three sections, 6(b) and 17A(b)(3), do not even proscribe particular conduct as being unlawful, a fact which this Court has found significant. *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 569 (1979). Moreover, there were no allegations in the record below that AMEX or OCC, respectively, failed to comply with these sections.

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[5] The SEC itself urged the Court of Appeals to avoid the implied private right of action issue and to affirm on the basis of Petitioner's failure to allege fraud or bad faith. (A. 4-5).

Second, while Section 19(g)(1) does require SROs to comply with their own rules, the Act expressly provides for *Commission* action to correct any violation of those rules. Also undisputed is the vastly increased and more flexible enforcement authority granted the Commission in the 1975 Amendments. The existence of express judicial or administrative remedies is a strong indication that private remedies should not be implied. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 19-20 (1979). *See also Touche Ross, supra*, at 571-72; *Cannon* v. *University of Chicago*, 441 U.S. 677, 742 (1979) (Powell, J., dissenting).

Third, Section 19(g)(1) was *added* by the 1975 Amendments. *Baird* v. *Franklin* and other cases under old Section 6(b)[6] obviously cannot stand as authority for an implied right of action under a statutory requirement that was not enacted until 30 years later. In fact, the new Section 6(b) was expressly patterned after Section 15A—the section of the Act which provides for regulation of national securities associations. (Senate Report at 27.) It is significant, therefore, that no case has ever held that there exists an implied private right of action against the National Association of Securities Dealers—the only national securities association regulated under Section 15A—for failure to comply with its own rules. The only case even raising the issue held that no private remedy could be implied under Section 15A. *Gustafson* v. *Strangis*, 572 F. Supp. 1154 (D. Minn. 1983).

Fourth, since the Act never included *any* provision regulating clearing agencies prior to the adoption of Section 17A as part of the 1975 Amendments, it would be impossi-

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[6] *See* Securities Exchange Act of 1934 (Act of June 6, 1934, c. 404, Title 1, Section 6, 48 Stat. 885).

ble to imply a private right of action from *Baird* v. *Franklin* and pre-1975 Section 6(b). Moreover, Congress' express findings with regard to Section 17A would predetermine a negative answer to the question of an implied remedy:

> This subsection [17A(a)(1)] would . . . *centralize in the Commission the authority and responsibility to regulate, coordinate and direct the operations* of all persons involved in the securities handling process toward the goal of a national system for clearance and settlement of securities transactions. (emphasis added)

Senate Report at 122; emphasis added.

Nor should this Court undertake such an implied right analysis here. In the only reported Court of Appeals decision raising the issue, the court below expressly declined to address it. (A. 5). More significantly, the analysis required by this Court's decisions in *Cort* v. *Ash*, 422 U.S. 66 (1975), *Touche Ross*, *supra*, and *Transamerica*, *supra*, would require a section-by-section statutory review under the tests of those decisions. For example, a number of recent decisions have found no implied private rights of action for alleged violations of SRO rules promulgated under other sections of the Act. *See, e.g.*, *Bennett* v. *United States Trust Co. of New York*, 770 F.2d 308 (2d Cir. 1985), *cert. denied*, 106 S. Ct. 800 (1986); *Jablon* v. *Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980); *Klock* v. *Lehman Bros. Kuhn Loeb Inc.*, 584 F. Supp. 210 (S.D.N.Y. 1984); *Colman* v. *D.H. Blair & Co., Inc.*, 521 F. Supp. 646 (S.D.N.Y. 1981); *Klitzman* v. *Bache Halsey Stuart Shields, Inc.*, 499 F. Supp. 255 (S.D.N.Y. 1980); *Russo* v. *Bache Halsey Stuart Shields, Inc.*, 554 F. Supp. 613 (N.D. Ill. 1982); *Lenowitz* v. *Philadelphia Stock Exchange*, 502 F. Supp. 428 (E.D. Pa. 1980). The result of such an analysis by this Court, thus, would not settle an important question of federal law with broad application. *See* Rule 17.1(c) of the Rules of this Court. Indeed, it

would not even dispose of this Petitioner's claim since he would then have to face the issue of his failure even to allege fraud or bad faith.

Petitioner strains to find a "conflict" in the application of the "preservation doctrine" of *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982). Once again, as Petitioner's own citation bears witness, the only "conflict" noted by the Second Circuit in this case was the difference between two district courts. (Petition 15; A. 5). Moreover, it cannot be asserted credibly that a duty which did not exist under a pre-amendment statute—the duty of a registered exchange or clearing agency to comply with all of its own rules—could be preserved by the amendment. Additionally, it would not be appropriate to apply the *Curran* preservation mechanism to the extensive modifications of the 1975 Amendments. As noted above, Section 6(b) was entirely rewritten on the pattern of Section 15A of the Act which provides for regulation of national securities associations. Further, prior to the addition of Section 17A to the Act by the 1975 Amendments, there were no cases implying private rights of action against clearing agencies because they were not directly regulated under the Act.

Petitioner concedes as much by arguing that the mere mention of *Baird* v. *Franklin* in a legislative report brings into operation the preservation theory of *Curran*. But the mention of *Baird* v. *Franklin* occurs in a footnote in a study of a subcommittee of an earlier Congress. The footnote relates to text which states that the Commission "does not have the power to directly enforce exchange rules" and that the Act does not "provide any express procedure whereby the Commission can itself see that exchange rules are enforced." Securities Industry Study, Report of the Subcommittees on Securities of the Committee on Banking, Housing and Urban Affairs of the United States Senate,

93rd Cong., 1st Sess. 27, n.21 (Committee Print 1973). Thus, if anything may be inferred from this reference to *Baird* v. *Franklin* it is that Congress identified the deficiencies in the Act which led to *Baird* and acted decisively to remedy them in the 1975 Amendments. The lack of focus of Petitioner's argument is epitomized in his assertion that the 1975 Amendments "codify" *Baird* v. *Franklin* when precisely the opposite is true. (Petition 17).

II. THE WRIT SHOULD NOT BE GRANTED TO REVIEW THE FRAUD OR BAD FAITH STANDARD BECAUSE:

A. There Is No Conflict Among The Circuits As To Whether Actions By An SRO To Comply With Its Own Rules Are Measured By A Fraud Or Bad Faith Standard.

Petitioner attempts to manufacture a conflict—where none exists—as to whether discretionary actions by an SRO to comply with its own rules are measured by a fraud or bad faith standard.

At the outset, it is notable that the Second Circuit gave no indication whatsoever that it perceived that its ruling in this case was either controversial or novel. Indeed, the Court of Appeals stated unequivocally that its decision was consistent with the views expressed by lower courts in the Second Circuit, as well as other circuits, in a line of decisions spanning at least the last forty years involving both stock and commodities exchanges:

> Courts have *consistently* held that "absent allegations of bad faith [an exchange and its officials] may not be held for discretionary actions taken in the discharge of their duties pursuant to the rules and regulations of the Exchange." *P.J. Taggares Co.* v. *New York Mercantile Exchange*, 476 F. Supp. 72, 76 (S.D.N.Y. 1979). We

> recently reaffirmed this view in *Sam Wong & Son, Inc.* v. *New York Mercantile Exchange*, 735 F.2d 653, 670 (2d Cir. 1984) ("*That bad faith is the standard of liability for suits against an exchange with respect to its taking action authorized by applicable law has been established at least since Daniel* v. *Board of Trade, 164 F.2d 815 (7th Cir. 1947)* . . . ."). That these decisions involved suits under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, makes no difference * * * Moreover, courts have applied the bad faith standard in suits alleging violations of discretionary rules by the securities exchanges as well. *See, e.g., Schonholtz* v. *American Stock Exchange, Inc.*, 376 F. Supp. 1089, 1092 (S.D.N.Y.) (dismissing complaint because allegations of exchange rule violations were not coupled with claims of fraud), *aff'd*, 505 F.2d 699 (2d Cir. 1974) (per curiam) and cases cited therein.

(A. 10-11; emphasis added).

Respondents submit that the Second Circuit correctly concluded that the law is settled. The leading case is, in fact, the decision of that Circuit in *Sam Wong & Son, Inc.* v. *New York Mercantile Exchange*, 735 F.2d 653 (2d Cir. 1984), where the plaintiff alleged that the New York Mercantile Exchange, which is an SRO under the Commodity Exchange Act (the "CEA"), 7 U.S.C. § 1 *et seq.*, and its governors and officers violated sections of the CEA and regulations of the Commodity Futures Trading Commission thereunder by failing to monitor the market in certain futures contracts and to take timely action to declare an emergency affecting trading in such contracts. In affirming the lower court's dismissal of Wong's complaint, the Second Circuit stated:

> [E]ven if there is a private cause of action for failure to declare or undue delay in declaring an emergency, this

> portion of Wong's complaint falls [sic] * * * *for want of allegations of bad faith.*

Id. at 670; emphasis added.[7]

Similarly in *P.J. Taggares Co.* v. *New York Mercantile Exchange*, 476 F. Supp. 72, 76 (S.D.N.Y. 1979), the court dismissed a complaint for failing to allege that fraud motivated the commodity exchange's action, holding:

> The Exchange and its officials * * * absent allegations of bad faith may not be held for discretionary actions taken in the discharge of their duties pursuant to the rules and regulations of the Exchange.

To the same effect is *Compania de Salvadorena de Cafe, S.A.* v. *Commodities Futures Trading Commission*, 446 F. Supp. 687, 691 (S.D.N.Y. 1978), where the court dismissed a complaint alleging that a commodity exchange's emergency action violated its rules because the complaint failed to allege bad faith. The court stated: "[t]he discretion of the [exchange] to declare and meet an emergency is * * * without limit except that the [exchange] must act in good faith." *See also, Lagorio* v. *Board of Trade of the City of Chicago*, 529 F.2d 1290, 1291 (7th Cir.), *cert. denied*, 426 U.S. 950 (1976) (court granted defendant exchange summary judgment because the plaintiff failed to allege that the board's discretionary action was taken in bad faith).

In rendering its decision below, the Second Circuit also relied on cases involving securities exchanges such as

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[7]Although the CEA was amended in 1982 to expressly provide for a bad faith standard, the Second Circuit in both this case and *Sam Wong* recognized that the 1982 amendment "merely codified existing case law under that statute." (A. 11). Petitioner concedes this point. (Petition 23).

Schonholtz v. *American Stock Exchange, Inc.*, 376 F. Supp. 1089 (S.D.N.Y.), *aff'd per curiam*, 505 F.2d 699 (2d Cir. 1974), where the district court stated:

> *[N]o case of which we are aware* has found an implied right of action for the violation *per se* of an exchange rule; allegations of such violation have been held to state a claim only where coupled with sufficient allegations of fraud on the investor.

376 F. Supp. at 1092; emphasis added.

Petitioner argues that *Schonholtz* is distinguishable because the court erroneously relied upon a line of cases against members of an exchange for alleged violations of stock exchange rules in which, he admits, the courts have consistently applied a bad faith standard *(e.g., Colonial Realty Corporation* v. *Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir.), *cert. denied* , 396 U.S. 838 (1969); *McMaster Hutchinson & Co.* v. *Rothschild & Co.*, [72-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,541 at 92,585 (N.D. Ill. 1972)).

However, these cases are no less persuasive because they deal with member firms rather than exchanges. It is obvious that the standard should be at least as stringent for claims against SROs as for claims against member firms, in that the exercise of discretion is inherent in the administration by an SRO of its own rules.

In the face of this overwhelming authority mandating a fraud standard for claims involving discretionary action by an SRO, Petitioner, without citation of a single authority, urges again in this Court that the commodities cases are "unreliable precedent." (Petition 23). This argument is unpersuasive. The action taken by the Respondents' Securi-

ties Committee in an effort to maintain a fair and orderly market so closely resembles the type of emergency action taken by commodities exchanges in those cases that the same standard of conduct should be applied.

In support of his position that there are conflicts which require resolution, Petitioner relies exclusively on two cases: *Baird* v. *Franklin, supra*, and *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976).[8] However, neither of these cases involves an alleged failure by an SRO to comply with its own rules. Thus, these cases are plainly distinguishable on their facts and, as such, create no conflict. *See*, Harlan, *Manning the Dikes, supra* at 553 ("[D]ifferences between the Courts of Appeals in two or more circuits will not be accepted as a conflict if they can fairly be accounted for on the basis of variations in the factual situations among the cases involved.").

Baird involved a claim against an SRO for *failing to take action to enforce compliance by* a member firm with the SRO's rules. There the New York Stock Exchange had knowledge that one of its members was guilty of conduct inconsistent with just and equitable principles of trade and had violated numerous of the rules and regulations of the stock exchange. Despite its knowledge of this clear violation of the exchange rules and regulations, the exchange took

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[8]Even assuming, *arguendo*, that the Second Circuit's decision in *Baird* is in conflict with its decision in this case, it cannot possibly create a conflict requiring resolution by this Court. As Justice Harlan once stated "contrary decisions between different panels of the same Court of Appeals will not be considered to present a reviewable conflict, since such differences of view are deemed an intramural matter to be resolved by the Court of Appeals itself." J.M. Harlan, *Manning the Dikes, The Record* 541, 552 (1958). *See also* Supreme Court Rule 17.

absolutely no action to discipline its member. It was this "*complete inaction*" that the Court found to be "a violation of § 6(b) of the Act" (141 F.2d at 244; emphasis added). Thus, *Baird* did not involve an instance of discretionary decision-making by the exchange.

Hughes, like *Baird*, involved a claim that an SRO had *failed to properly supervise a member firm*. In *Hughes*, the New York Stock Exchange could offer no explanation for lifting previously imposed restrictions on a member firm which was in violation of the Exchange's net-capital rule. Although the Ninth Circuit recognized that "[a]s long as the Exchange takes prompt action to investigate alleged violations, and, having ascertained that violations exist, takes action reasonably designed to restore compliance with the rules, courts should not substitute their retrospective judgment concerning the appropriate action" (534 F.2d at 170), it held that the "failure of the Exchange to take constructive action toward the underlying problems of [the member] constitutes a clear breach of its duty." *Id.* at 174.

In sharp contrast, the case at bar is based on an implied right of action under the Act for alleged failure by SROs to comply with their own rules—not a failure to supervise their members or to enforce compliance by their members. Thus, *Baird* and *Hughes*, which arguably establish a negligence standard for alleged inaction on the part of an SRO to enforce compliance with its rules or to properly supervise its members, are wholly inapposite to the instant case. Indeed, no case that we have found involving claims against an SRO for discretionary actions taken pursuant to its rules has applied a lesser standard than that of bad faith or fraud.

Regardless of whether a negligence standard would be appropriate when an SRO has failed to carry out its oversight responsibilities with respect to members, it should not

be applied to claims which seek to "second guess" the discretionary decisions of an SRO in administering its marketplace. Where, as here, the Respondents made a determination pursuant to their rules which specifically authorized them to exercise discretion, the cases make clear that their conduct is to be measured by a bad faith or fraud standard.

The rationale for this rule is that SROs are constantly faced with the responsibility of making decisions and taking action of an immediate nature affecting their markets and the terms and conditions of contracts traded in those markets. Virtually all such decisions made by SROs have the potential for disappointing some investors.[9] If all disappointed investors had the right to sue an exchange or clearing agency merely because they disagreed with the good faith decisions made by its officers and representatives, not only would the legal system be overwhelmed, but courts would constantly be required to substitute their judgments concerning complex market decisions—decisions which

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[9]As noted above, Petitioner blatantly distorts the record in this case when he characterizes Respondents' Securities Committee's action as "whimsical, capricious and disastrous" and states that "[n]o one has taken issue with the proposition that the SROs' decision not to adjust was clear error" and that "the failure to adjust resulted in a misallocation of approximately $15 million." (Petition 26). On the contrary, Respondents vehemently deny these allegations. *See* pp. 3-4, *supra*. This issue was never reached by the Court below simply because, as no bad faith was alleged, its resolution was wholly irrelevant to the Respondents' motion to dismiss.

Congress, in adopting the self-regulatory approach, entrusted to the SROs subject to oversight by the SEC.[10]

The Court of Appeals expressed the logic and fairness of applying a fraud standard:

> There are good reasons why a negligence standard has not been and should not be applied to SRO decision making. First, applying a negligence standard in such cases would force a court to substitute its judgment for that of the experts on the exchange.
>
> * * *
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> Second, such an intrusion would conflict with the Congressional scheme of exchange self-regulation. As the Supreme Court recognized in *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 352 (1963), quoting Justice Douglas during his tenure as Chairman of the SEC, the intention of the Act was "one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" A negligence standard would bring the government's "shotgun" into almost everyday use.
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> Third, this governmental intrusion, particularly if it did not employ statutory standards of review, would only serve to increase market uncertainty. Every decision made by a SRO would be subject to litigation and

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[10] It is noteworthy that the SEC filed an *amicus curiae* brief on the appeal to the Second Circuit in which it supported Respondents' position that fraud or bad faith was the appropriate standard to be applied to the discretionary decision-making involved in this case. As the Court in *Hughes, supra*, made clear, endorsement by the Commission of an exchange's action is "significant" and should be given "considerable weight." 534 F.2d at 170.

> judicial review because "any decision the Committee makes will benefit one group of option investors at the expense of another." 633 F. Supp. at 1261-62. The resulting uncertainty benefits no one. *See, e.g.*, J. Pappas & E. Brigham, *Managerial Economics*, 82-86 (3d ed. 1979). As the SEC pointed out in its amicus brief, "[w]hat is essential in such a situation, for the benefit of all investors, is that the decision be made fairly and considered final."

(A. 11-12).

B. Section 17A Of The Act Cannot Be Read To Preclude A Fraud Or Bad Faith Standard.

In a fresh lunge at Section 17A of the Act, Petitioner has divined a new reading of that section which he offers for the first time in his Petition in this Court. After conceding reluctantly that, after the enactment of Section 17A, clearing agencies "... operate independently of exchanges" (Petition 27), he focuses on the phrase "prompt and accurate clearance and settlement of securities transactions" and gives it a meaning which cannot be found in the statute itself, its legislative history nor in any other authority. (Petition 28). Apparently, Petitioner suggests that this phrase, which appears throughout Section 17A, deprives OCC, an SRO and registered clearing agency, of any power to apply the Adjustment Rule in any manner inconsistent with Petitioner's supposedly "accurate" reading of it. The argument is seriously flawed in several respects.

First, as Petitioner himself recognizes, the "prompt and accurate" language resulted from the "paperwork crisis" of the late 1960's and has nothing whatever to do with the breadth of an SRO's discretion to interpret and apply its own rules. (Petition 31).

Second, the Adjustment Rule itself provides that the Securities Committee of OCC shall make adjustments which the "... Committee in its *sole discretion* determines to be fair to the holders and writers of such option contracts." (emphasis added) (A. 8, n.4). As noted above, in 1983, OCC's By-laws and rules were approved by the Commission as meeting the requirements of Section 17A(b)(3)(F), which requires that "the rules of the clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions." Thus, the By-law which Petitioner claims is confined by the "accurate clearance" language of Section 17A contains a "sole discretion" standard which has, itself, been approved by the Commission as being "designed to promote ... accurate clearance...."[11]

Third, it is settled that SROs have discretion in determining the meaning of their own rules and that courts should not treat such discretion as an issue of statutory interpretation. *Shultz* v. *SEC*, 614 F.2d 561, 570-1 (7th Cir. 1980); *Fogel* v. *Chestnutt*, 533 F.2d 731, 753 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); *Intercontinental Industries, Inc.* v. *American Stock Exchange*, 452 F.2d 935, 940 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972); *Moses* v. *Burgin*, 445 F.2d 369, 382 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971). This is yet another reason why this Court should not consider the "fraud or bad faith" standard as anything but well settled.

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[11]As noted above, Petitioner's persistent misstatement that an adjustment was "required" by the language of the Adjustment Rule (Petition 30) is a semantic contortion which ignores the phrase "sole discretion" and was emphatically rejected by the Court of Appeals. (A. 12-13).

III. THE DISMISSAL WITH PREJUDICE WAS PROPER.

Petitioner argues that, even if fraud or bad faith is the appropriate standard, dismissal with prejudice was improper at this stage of the proceeding. Petitioner offers no reason whatsoever why this issue is deserving of a grant of *certiorari* by this Court. In any event, as even Petitioner recognizes (Petition 37), if it is apparent that Petitioner could plead no set of facts to support a claim of bad faith or fraud the dismissal was perfectly appropriate.[12]

Such is the case here. Indeed, Petitioner, in a moment of candor, wrote in his brief to the Second Circuit that "there simply are no 'circumstances constituting fraud' . . . to be pleaded," Reply Brief of Plaintiff-Appellant at 23, *Brawer* v. *The Options Clearing Corporation and American Stock Exchange, Inc.*, (2d Cir. 1986) (No. 86-7416). Petitioner's statement below was a direct admission that he has not and cannot meet a fraud standard.

Petitioner now proffers the disingenuous argument that "only two limited purpose depositions" (Petition 35) have been taken and suggests that further discovery might provide him with the facts to sustain a bad faith claim. Petitioner noticed only two depositions and he took two depositions: those of the chairman and chief executive

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[12] Both *McLain* v. *Real Estate Board of New Orleans, Inc.*, 444 U.S. 232 (1980) and *Hospital Building Co.* v. *Trustees of Rex Hospital*, 425 U.S. 738 (1976), relied on by Petitioner, are inapposite. In those cases this Court reversed the district courts' dismissal of antitrust complaints finding sufficient facts pleaded to establish that Respondents' activities had an effect on interstate commerce. In sharp contrast, here there simply are no facts from which bad faith can be inferred.

officer of OCC and the executive vice president of Amex. The so-called "limited purpose" depositions taken by Petitioner were ordered by the district court, at the request of Petitioner, for the specific purpose of enabling Petitioner to explore the facts relating to his claim of bad faith. Thus, the "limited purpose" was the very purpose for which Petitioner now claims he still needs discovery.[13]

Petitioner's claim that there is a "close" question as to the bad faith of the Securities Committee in making its decision with respect to an adjustment is premised primarily on the argument that the Committee delayed taking action because it did not hold a meeting until four days after the announcement of the Phillips tender offer coupled with the unsupported suggestion that, because of the statements made by Respondents' staff during this period, the Commit-

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[13] Petitioner's reliance on *Scheuer* v. *Rhodes*, 416 U.S. 232 (1974), is misplaced. There this Court termed the district court's dismissal of a complaint for lack of subject matter jurisdiction "premature" only after it determined that petitioner should have the opportunity to obtain evidence to support its claims. This Court held:

> When a Federal Court reviews the sufficiency of a complaint, *before the reception of any evidence either by affidavit or admissions*, its task is necessarily a limited one. (emphasis added)

Id. at 236.

Here Petitioner has already had discovery and submitted both deposition testimony and affidavits in support of his fraud claim. The Second Circuit, after considering the evidence, determined that the complaint was fatally flawed. Petitioner should not be permitted to have a second bite at the apple when the facts allegedly constituting the fraud have already been discovered, argued and rejected by the Second Circuit.

tee was forced not to adjust by a desire to avoid lawsuits by disgruntled buyers of Phillips put options.

First, as the Second Circuit recognized (A. 14), the so-called delay was precipitated by the necessity to obtain and review the voluminous prospectus issued by Phillips. The meeting was promptly held following receipt of the offering materials. In any event, the courts have clearly established that SROs are permitted sufficient time to review pertinent information and to deliberate before taking action affecting the interests of investors. For example, in *Sam Wong & Son Inc.* v. *New York Mercantile Exchange*, *supra*, the exchange waited three to four days after the emergency became apparent to hold a meeting and suspend trading in certain futures contracts. The plaintiff challenged the exchange's "delay" in taking the emergency action and the Court held that the plaintiff "could not allege that this delay was taken in bad faith." 735 F.2d at 671. *See also*, *Miller* v. *New York Produce Exchange*, 550 F.2d 762 (2d Cir. 1977) (where the Court held a five day delay in closing the market did not evidence bad faith and "was in keeping with the 'broad and flexible powers' granted the exchange to enable it to insure an orderly market." 550 F.2d at 767.)

Second, the deposition testimony unequivocally demonstrates that the members of the Securities Committee did not take into account possible lawsuits by disgruntled investors when making their decision. Furthermore, if the mere fact that the Respondents might escape lawsuits by one group of investors were sufficient to amount to bad faith, then it is submitted that allegations of "bad faith" could be made with regard to nearly every decision by AMEX or OCC because each time they make a decision affecting the

market it necessarily benefits one group of investors at the expense of another group."[14]

Petitioner also attempts to conjure up a self-interest motive on the part of Respondents by contending that the adjustment decision benefited Respondents by resulting in increased trading volume and revenues. (Petition 35). Here again, *Sam Wong, supra*, is precisely on point. Wong's complaint alleged that the exchange board members were affiliated with member firms which were required to guarantee outstanding contracts in the case of a default. As is usual with most clearing agencies, the clearing members were required to contribute to a fund which could be used to cover defaulted contracts in the case of the financial collapse of an individual firm. The Second Circuit held that such a remote and speculative financial interest was insufficient to amount to an allegation of bad faith:

> [i]f such a degree of self-interest were allowed to demonstrate bad faith, then exchange-board members involved in futures markets would inevitably be subject to bad faith charges, and the concept of exchange self-regulation would be undermined.

735 F.2d at 672 (quoting *Jordan* v. *New York Mercantile Exchange*, 571 F. Supp. 1530, 1545 (S.D.N.Y. 1983)). Respondents in the case at bar had an even lesser interest in the Phillips stock options than the defendants had in the

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[14] Petitioner attempts to liken this case to *Daniel* v. *Board of Trade*, 164 F.2d 815 (7th Cir. 1947), where the Seventh Circuit found bad faith sufficiently alleged. In so doing, Petitioner selectively quotes from that case and deletes the critical allegation that the Respondents there acted "'willfully, maliciously, or for their own personal gain through profits accruing to them through their individual brokerage houses.'" 164 F.2d at 818. Here, of couse, no allegation of personal profit motivation can be sustained.

futures contracts in *Sam Wong*. Only officers of the AMEX and OCC served on the Securities Committee which made the decision; no member firms who might have had a financial interest in the options played any part in making the decision. Furthermore, the depositions, taken at Petitioner's instance, show that arbitrage simply was not considered in making the decision whether to adjust.

In sum, Petitioner, with the benefit of discovery of both Respondents on this very issue, has completely failed to offer any facts from which fraud or bad faith could possibly be inferred.

CONCLUSION

For the reasons stated herein, the Petition for Writ of *Certiorari* should be denied.

Respectfully submitted,

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